

A New Approach to Tax Reform

For the past several months, our Eco/Eco group has been looking at tax reform and tonight we would like to tell you where we are and get some questions and responses.

The group was convened by Rep. Ted Koffman, with Peter Cox as co-chair of the Eco/Eco forum. We were joined by Sen. Peter Mills, Rep. Janet McLaughlin and Rep. David Lemoine. Chris Hall of the Chamber of Commerce, Kit St. John of the Maine Center for Economic Policy and journalist Doug Rooks rounded out the group. We received constant help from Tony Neves of Maine Revenue Services tax office who generously pointed out faulty assumptions and ran the numbers for us.

As a group we have had the luxury of being able to look at the big picture of tax reform without immediately being bombarded by special interests or those looking at the problem from a limited perspective. Thus, we think our initial proposals have some internal logic. They fit together.

Tax reform has become a suddenly popular cause. But why now? And why do we need reform? Maine's tax system is often described as burdensome and archaic, with some justification. Few states still tax personal property (business equipment). But all states, including Maine, work with tax systems designed for the 1950s, when the economy was vastly different than it is today. Back then, manufacturing was the big employer and the backbone of the economy. Accordingly, we taxed not only sales and personal property but business inventories. The economy of the 21st century is increasingly dominated not by the production of goods, but the provision of services, the purchase of real estate, and consumption of non-essential goods.

Our plan recognizes that we need to shift the burden from a rapidly declining industrial base and instead tax growing economic sectors (services, second homes, dining out) in order to provide broad tax relief and also tax more efficiently.

We also recognize that in the current political climate we also needed a strict pledge of revenue neutrality. Powerful forces are at work both to lower taxes to reduce the tax burden, and conversely to increase revenues to fill a looming state budget deficit. Neither of these aims is a proper goal of tax reform, which instead attempts to reshape the system, leaving the business of raising or lowering taxes to the Legislature's budget process. This plan proposes tax reductions to match any

potential increases, and we also seek to ease the burden on the resident taxpayer, especially the property taxpayer.

To do this, we have tried to locate sources of tax revenue that are available but untapped or under-utilized. We found two especially clear areas. First, the people buying the valuable shorefront property that is causing the hardship to others, what we call the Chebeague factor. And second, tourists who want to enjoy what we have but make a relatively small contribution toward its preservation.

We have sought revenue where it is available. But since such revenue is not available to everyone on a local basis -- and our old friend Mary Adams stands ready to make sure it is not redistributed on a statewide basis -- there is a tradeout. Towns that have available the new sources of revenue can tap into them and in some cases drastically lower their property taxes. In return, they will give up money they now receive from the state in revenue sharing and that money will go to the towns who do not have these sources of revenue.

Let us be specific. We are proposing a constitutional amendment that would allow towns, at their option, to tax second homes at twice the rate of primary homes as is done in other states, most notably Utah. If every town did this -- and not every town would find it worthwhile -- it would result in a tax shift of from \$300 million to \$400 million from resident to non-resident property owners and drastically lessen the Chebeague factor. And it would not deter the out-of-state buyer because the towns with the most valuable property also tend to have the lowest tax rates now.

Coupled with this would be to allow those towns that wanted to levy a meals and lodging tax. (Part of such a tax increase would go to the state; a one-cent increase would bring Maine to the New England median.) With a each cent increase producing \$23 million statewide, some towns would benefit more than others. Frankly, the Bar Harbors and the Kennebunkports would be sitting pretty. In return, they would give up revenue sharing and that money would go to the towns who did not have their tourist economies and who, by the way, would otherwise oppose such a local option tax.

Let's run down some of the other concepts in our plan.

- Remove the existing homestead tax which covers only the first \$7,000 of value and is insignificant to those who do not really need it. The \$40 million saved is more than enough to fund a simplified and expanded circuit breaker

to give relief to people who are truly overburdened by their property taxes.

- Raise the level at which towns receive revenue sharing to at least \$10, as enacted under the “Revenue Sharing 2” plan, to provide more money to those with higher tax rates.
- Leave the tobacco tax alone but raise the alcohol taxes, which are now 12 cents on a bottle of wine and 19 cents on a six-pack of beer (less than the bottle deposit), and have not been increased in 20 years.
- Put teacher pensions that are now funded entirely by the state into the school funding formula. Create a benchmark system – such as the “essential services” program requested by the Legislature -- to allow school funding to be more related to the actual cost of providing a sound education.
- Increase the percentage of school funding paid by the state to previously legislated levels, but require a local share of retirement costs, and fiscal restraint in the form of consolidated services and the per-pupil cost benchmarks.
- Encourage efficiencies on the municipal level as well. The state now directly returns more than a billion dollars a year to schools and municipalities, amounting to about 40 percent of the state budget.
- Enact a gross receipts tax at a much lower rate to replace the 5 percent sales tax and provide additional revenue.
- Increase the income tax brackets, which now include a top rate at one-sixth the federal level, to provide substantial relief for those with lower and moderate incomes.
- Increase the rainy day fund from 6 percent to 10 percent, placing an effective cap on spending all the increased revenue in boom years and reducing the negative effects of economic downturns.
- Phase out BETR and remove the possibility of double dipping with TIFs.

This is where we start. We hope your thoughtful comments, in the Eco/Eco tradition of looking at the broad picture, will help us to improve what we have come up with so far.

Further Discussion

This section provides more detailed explanations of some of the principal recommendations, and the thinking behind them:

Gross Receipts Tax

It is our belief that expanding the sales tax, the solution proposed in most tax reform plans to date, is an arduous and perhaps impossible process. Three states have actually enacted significant expansions of their sales taxes to cover services; two of them repealed the expansions before they took effect, and Florida did so just two weeks after its effective date.

The problem is that figuring out which of the current 147 exemptions to repeal (41 of them costing the state more than \$1 million in lost revenue) is fraught with difficulty. Each group that currently has an exemption fights fiercely to keep it. Removing exemptions has been attempted repeatedly by the Taxation Committee in recent years; no exemptions have actually been repealed, and several new ones have been added.

The gross receipts tax takes an entirely different approach. It applies not to consumer sales but to business transactions – an indirect tax. Because the state now exempts 63 percent of all goods and services from the sales tax – collecting on only 37 of current sales – a very broad gross receipts tax could be imposed at about half the 5 percent rate while still raising about 25 percent more than the current sales tax. This example does include simple “anti-pyramiding” exemptions for materials and energy used in manufacturing, but taxes all other goods and services at a 2.55 percent rate. This would provide an equivalent attraction to the 1986 federal income tax reform effort, which dramatically lowered rates by eliminating most exemptions.

The gross receipts tax also addresses the growing non-profit sector, including hospitals, social service agencies, and private schools and colleges, not by taxing the non-profits, but by taxing the sales made by other businesses to the non-profits.

New Mexico has had a gross receipts tax since the 1930s, paired with a state income tax. New Hampshire adopted a gross receipts tax, which it calls the “Business Enterprise Tax,” as part of its response to a school funding crisis – though at a lower rate than Maine would need to replace its sales tax.

Abolishing the sales tax would also set Maine apart from all of its New England neighbors except New Hampshire, and help get it out from under the “highest tax burden” stigma with a new perception of being innovative and forward-thinking and perhaps a national model. All states with sales taxes (46 of them) have a similar problem.

Property Tax Relief

The plan addresses the demand for broad property tax relief contained in at least two current referendum proposals, and implicitly represented by shortfalls in state funding of education which began in the early 1990s. The state has long pledged 55 percent support for operating expenses; it currently provides just over 43 percent. Our plan would fill this gap, but not without additional expectations of local school districts.

They would have to bear a share of the cost of teacher retirement expenses in the future (though exempted from the unfunded liability now being paid off), and would be tested against state formulas showing essential or basic funding, rather than the much higher per pupil costs some districts are showing. Overall, education costs are increasing about twice as fast as inflation, and much faster than average teacher salaries.

There would also be incentives for consolidation which may mean fewer schools, in some instances, but would also create administrative mergers and efficiencies in Maine’s 293 school districts which now serve, on average, fewer than 1,000 students, K-12.

We believe the state should get out of the business of broad, unfocused property tax relief (the current homestead exemption) and instead provide more targeted tax relief for individuals through the circuit breaker program. The current \$1,000 cap on payouts is not much help to an elderly couple with a \$6,000 tax bill. Under the previous, 1989 eligibility guidelines, the couple could qualify for up to \$5,000 in aid if they meet the income standards.

The homestead exemption would be replaced by the local option of taxing second homes at up to twice the rate of primary residences. Rather than \$40 million of direct state spending, this could provide up to 10 times that much -- \$400 million -- in relief to resident property owners. And since this would be a local decision, it

fits neatly with the property tax as a local tax.

Sin taxes

Several states are continuing to whack cigarette smoking with much higher taxes. Now that Big Tobacco is no longer resisting, the sky appears to be the limit; Massachusetts recently voted a \$1.50-a-pack tax to stem a budget deficit, topping Maine at \$1. But that \$1 is already triple the Maine tax four years ago, and we think smokers deserve at least a short reprieve.

Alcoholism and alcohol abuse also take a huge toll on the health and longevity of Mainers, yet we tax alcohol at almost trivial rates. The beer tax amounts to just 19 cents a six pack, less than the bottle deposit, and less than the sales tax on most brands. Tripling the tax (an additional 42 cents a six pack) could discourage drinking a bit, provide funding for treatment programs, and give a modest boost to state revenues.

Income taxes

Maine has a progressive income tax, with four brackets ranging from 2.5 to 8.5, but it functions more like a flat tax because the top bracket threshold is set so low – just \$16,500 for individuals, \$33,000 for couples. By contrast, the federal top rate does not kick in until \$200,000 of taxable income.

Our proposal would provide relief for all income taxpayers by raising each of the bracket thresholds, but would provide the greatest relief for low and moderate income taxpayers. An expanded earned income tax credit, in line with the more generous federal EIC, would help wage-earners with dependents, and compensate for some of the regressive effects of the expanded gross receipts tax.

Revenue Sharing

The Revenue Sharing 2 formula, which deducts the first \$10 of the local tax rate from consideration for funding, was enacted by the Legislature to distribute any surplus tax revenues – of which there have been none to date. But Rev. 2 is a fairer formula for the overall program, which last year distributed \$109 million. We direct school aid in greater amounts to communities with a greater need, and Rev. 2 uses the same principle for municipal aid. It would particularly benefit such service center communities as Augusta, Waterville and Lewiston (plus many

smaller ones) that have recently lost population as residents move to suburbs with cheaper land and lower tax rates, while still relying on the city for shopping and public services. It can thus be considered a significant anti-sprawl incentive.

By providing a 25 percent boost, either in county budget aid or increased municipal aid, it's more likely that municipalities will endorse the shift. County aid is equivalent to municipal aid, since, aside from state and federal aid, county budgets are now funded by property tax assessments.

A Summary of Key Tax Reform Recommendations

The following steps would increase state revenues or reduce state spending:

- Gross receipts tax at 2.55% to replace 5% sales tax **\$242 million**
- Repeal current \$7,000 homestead exemption **\$40 million**
- Triple beer and wine taxes **\$23.5 million**
- Increase rooms and meals tax from 7 to 8% **\$23.5 million**

Total Increases: \$329 million

The following steps would decrease state revenues or increase transfers to municipalities and school districts:

- Increase school funding to 55% of operating costs **\$181 million**
- Increase income tax brackets and raise EIC **\$100 million**
- Provide additional local or county revenue sharing **\$33 million**
- Restore 1989 circuit breaker property tax levels **\$15 million**

Total Decreases: \$329 million

The following steps would have no impact on state revenues, or an impact that is undetermined or only apparent in future tax years:

- Allow, by local option, taxing non-primary residences at up to double the regular assessment. This replacement for the state homestead exemption program would not increase or decrease overall property tax revenues, but would provide up to \$300-\$400 million in relief for residential taxpayers.
- Repeal the personal property tax and thus end BETR and the “double dip.” Details require further negotiation.
- Allow a local option of up to 2 percent to be added to the rooms and meals tax
- Require local contributions to teacher retirement fund, which is now fully state funded. The state would still pay 55 percent, as with operating expenses, but over time it would reduce the state liability and increase local responsibility. Retirement expenses now total \$161 million annually.
- Increase the Rainy Day fund capture of excess tax revenues to 10

percent. This would collect \$240 million, at current budget levels, up from the 6 percent saved in the 1990s.

- Switch municipal revenue sharing (5.1% of broad-based tax collections) from the Rev. 1 formula to Rev. 2. The latter disregards the first \$10 of the tax rate, targeting aid specifically to communities with high tax rates. The \$33 million in additional local (or county) revenue sharing would facilitate the switch.

Other Recommendations:

Create a state plan to encourage effective regionalization of school and local government services, to ensure that increases in state aid do not just lead to more local spending. The state can provide incentives by guaranteeing existing levels of school or revenue sharing aid for up to five years, permitting localities to recapture and invest the savings from consolidation during that limited period.